THE INVESTMENT ASSOCIATION

SUMMARY REPORT

Supporting UK Productivity with Long-Term Investment

The Investment Association's Productivity Action Plan

March 2016

FOREWORD

Guy Sears
Interim Chief Executive
The Investment Association

THE INVESTMENT INDUSTRY PLAYS A CRITICAL ROLE IN THE ECONOMY, AS THE CONDUIT THROUGH WHICH MONEY MOVES FROM SAVERS TO BUSINESSES. WE RECOGNISE THAT THIS IS AN IMPORTANT ROLE, PUTTING US IN A SPECIAL POSITION TO BE ABLE TO IMPROVE OUR NATION'S ECONOMY. THE GOVERNMENT'S AMBITION IS THAT BRITAIN BECOMES THE RICHEST OF THE MAJOR ECONOMIES BY 2030, WITH THE HOPE THAT OUR CHILDREN'S LIVES WILL BE BETTER THAN OUR OWN.

But we can only achieve a more prosperous Britain for all if we are able to tackle the UK's productivity problem. It is a chronic issue. Productivity growth in the UK remains 16 percent below its pre-2008 trend rate. In the long term, lower productivity can only mean lower wages, lower living standards and a less competitive economy. Crucially, it also means lower rates of return for the investors our industry serves on a day-to-day basis. That is why we agree with the Government that now is the time to act, and we are committed to using our investment industry's unique role in the economy to enact reforms that can improve our economy for all.

The Action Plan outlines how we as investors can play a fundamental role in rebuilding the UK's economic foundations for a better future. As the Introduction records its genesis was from leading members of the industry; and the published Action Plan is the product of hours of work by some of the brightest minds in the British investment industry and wider economy.

We call for a series of targeted and significant reforms to the way different parts of the economy communicate with each other, so as to give companies the confidence to invest their capital in productive enterprises. Most of all, the Action Plan seeks to deliver ambitious and achievable remedies to the ills of some of the most serious causes of short-term thinking in the British economy.

The Action Plan promotes a series of actions to improve long-term investment; importantly, long-termism is not a blind attitude. Asset managers have to act in the best interests of their clients, these best interests may sometimes result in actions which appear to be short term, demanding change from companies or opposing management strategies, but are actually in the long term interests of the end client. Many of the recommendations are designed to improve the flow of information and feedback on the issues that are likely to matter most.

The underlying rationale is clear, stronger businesses and economies deliver the exceptional long-term investment returns that the many millions of people, whose savings and investments are managed by our industry, both demand and deserve.

The full Action Plan can be downloaded from
http://www.theinvestmentassociation.org/media-centre/productivity-action-plan.html

EXECUTIVE SUMMARY

SINCE 2010, THE UK HAS OUTPERFORMED IN JOB CREATION AND GDP GROWTH. PRODUCTIVITY GROWTH, HOWEVER, REMAINS 16 PERCENT BELOW ITS PRE-2008 TREND RATE. EVEN TAKING INTO ACCOUNT POSSIBLE MEASUREMENT ISSUES AND SECULAR CHANGES, THIS SHORTFALL IS LARGE – AND OFTEN REFERRED TO AS THE 'PRODUCTIVITY PUZZLE'.

In July 2015, the Chancellor published "Fixing the Foundations: Creating a more prosperous nation," a comprehensive plan setting the agenda for the whole of Government over the current Parliament with an aim to reverse the UK's long-term productivity problem. The Investment Association (the IA) welcomed this and committed to developing an Action Plan on how the investment industry can play its part by improving productivity with long-term investment.

Productivity is about how well people combine resources to produce goods and services. It is about creating more from less and, through the process of renewing physical and intangible capital, it provides the essential ingredients of wealth creation and economic prosperity. For productivity to improve, businesses and investors need to be able to invest for the long term. Expanding the productive capacity of a modern economy requires long-term investment in assets such as infrastructure, research and development, factories and equipment and real estate.

An efficient capital market should be configured to transfer savings from today into investment tomorrow and growth the day after – but questions loom about the supply of long-term finance critical for achieving productivity improvements. As a share of GDP, investment in the UK has ranked in the lowest 10 percent for 16 of the last 21 years[1]. In short, capital investment in the UK is too low.

The post-financial crisis agenda quite rightly focused on developing regulation to address the weaknesses exposed to reduce the probability and cost of any future disruption. Crucially, however, there is evidence that the post-crisis system is not well structured to facilitate long-term investment approaches and the provision of growth capital.

All the way from individual savers to the decision making of corporate leaders, there are multiple reasons for this. From the asset allocation of pensions and insurers, to the incentives and governance of the investment strategies deployed, all the way down to the individual portfolio decisions and engagement with corporate leaders: more attention should be paid to the alignment of incentives with the long-term investment needs of the economy.

Addressing these impediments might sound nebulous but is critically important for the functioning of UK economy. More efficient matching between the requirements of savers with the real-economy demands for finance is much more than an investment chain of intermediation. It is the cycle of capital that contributes to confidence, job creation and business investment, all the way from an SME raising money to invest in new machinery to multibillion pound infrastructure projects.

Reflecting the wide-ranging nature of these challenges, the project Steering Committee developed a set of fundamental principles to define an ideal framework for how investors can contribute to productivity improvements with long-term investment. This directed the review's diagnosis of the current system's short-comings and the identification of solutions to address these challenges.

> "IT IS THE CYCLE OF CAPITAL THAT CONTRIBUTES TO CONFIDENCE, JOB CREATION AND BUSINESS INVESTMENT. . ."

[1] OECD stats database: quarterly National Accounts

INVESTOR PRODUCTIVITY PRINCIPLES

1. **Enhance company reporting for efficient capital allocation:** *through investment and analytical expertise, the investment industry will seek to identify and finance those companies contributing productive growth in the economy.*

2. **Enhance investor stewardship and engagement:** *the investment industry will engage with companies to help them achieve sustainable value creation over the long term and support investments in improved productivity.*

3. **Simplify behavioural incentives and the investment chain:** *the investment industry will work to ensure that the agreed incentives and governance of the investment chain ensure a clear alignment with clients' long-term investment objectives.*

4. **Develop efficient and diverse capital markets:** *as key capital market participants, the investment industry has a key role in the development of asset classes and the efficient functioning of capital markets.*

5. **Overcome tax and regulatory impediments to the provision of long-term finance:** *the investment industry should contribute to the debate on the tax and regulatory impediments to investment so as to ensure the right long-term outcomes for clients.*

In theory, pension funds, insurance companies, and other asset owners all have a natural alignment with the long-term financing needs of the economy. However, the capital models of well-meaning solvency and prudential regulation are inadvertently leading to excessive de-risking in asset allocation and impeding the supply of longer-term forms of capital, such as equity, infrastructure and private placements.

This is leading to an over-emphasis on short-term market risk in prudential regulation. This is, in turn, embedding a focus on volatility and benchmark tracking error in the governance of the investment strategies deployed, rather than the use of informed judgement of longer-term firm-level risks, consistent with the investment horizons of clients.

The relationship between asset owners and asset managers is a critical juncture in determining portfolio strategies. It should be formulated in a way that ensures that asset managers are able to meet their clients' investment needs and focus capital on the long term. These behavioural incentives should drive long term decision making, efficient allocation and embed a stewardship approach.

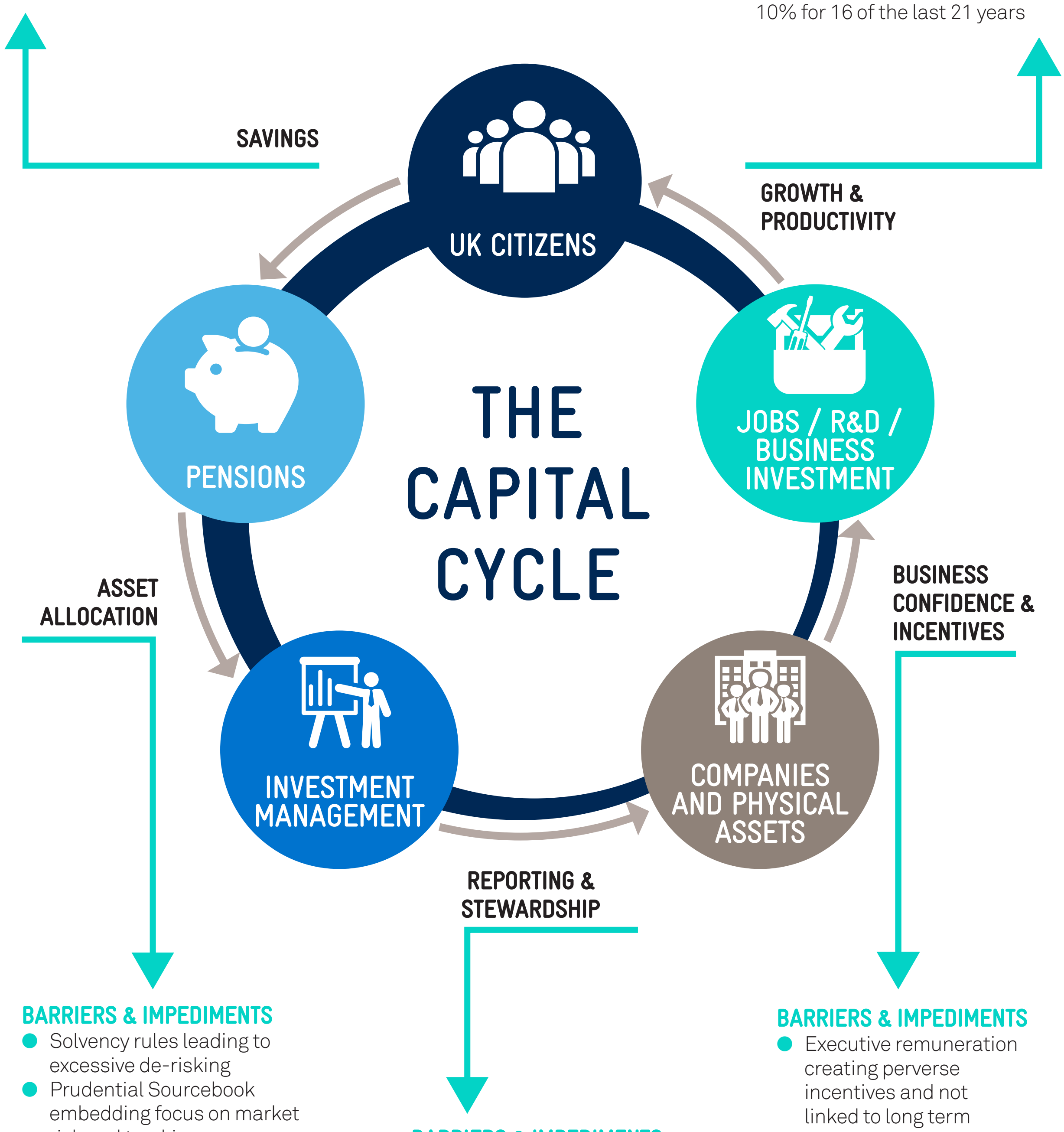
For there to be efficient allocation of capital by asset managers that effectively supports and challenges companies' productivity and capital expenditures, then company reporting, accounting standards and investment research must enable such analysis by asset managers. Equally, supporting long-term investment and productivity requires effective dialogue between investors and companies. By exercising stewardship responsibilities effectively, investors are well placed to ensure companies adopt a long-term approach.

Finally, taking steps to develop efficient and diverse capital markets is a crucial part of ensuring market confidence and protecting our end clients' interests. Here, more can be done to improve the efficiency of the capital raising process for both equity and non-equity capital and to expand the diversity of financing options.

Ensuring a supply of long-term finance adequate to address the needs to improve UK productivity will be a difficult task and the solutions are not simple. This is a challenge that calls for a multifaceted response and a package of measures: no single magic bullet will improve productivity. The Action Plan comprises a package of five overarching objectives and a series of recommendations and tangible actions to deliver these. Each represents a future work programme in its own right.

BARRIERS & IMPEDIMENTS
- Unequal treatment of DB and DC schemes
- Barriers for DC scheme making long-term investments

BARRIERS & IMPEDIMENTS
- Productivity growth remains 16% below its pre-2008 trend rate
- As a share of GDP, investment in the UK has ranked in the lowest 10% for 16 of the last 21 years



BARRIERS & IMPEDIMENTS
- Solvency rules leading to excessive de-risking
- Prudential Sourcebook embedding focus on market risk and tracking error
- Mandates not always aligned with long-term approach and stewardship

BARRIERS & IMPEDIMENTS
- Quarterly reporting short term and lacking focus on productivity
- Need for better reporting and dialogue on capital management
- Need for engagement to focus on long-term value creation and productivity

BARRIERS & IMPEDIMENTS
- Executive remuneration creating perverse incentives and not linked to long term
- Tax debt-bias in funding structures leading to financial stability risks

ROLE OF INVESTORS IN CONTRIBUTING TO PRODUCTIVITY

INTRODUCTION

In July 2015, the Chancellor published "Fixing the Foundations: Creating a more prosperous nation," a comprehensive plan setting the agenda for the whole of Government over the current Parliament with an aim to reverse the UK's long-term productivity problem. The Government's ambitious and wide-ranging framework for raising productivity includes 15 key areas, built around two pillars: first, encouraging long term investment, and secondly, promoting a dynamic economy.

The Investment Association (the IA) welcomed this and, following an exchange of letters between the Chancellor of the Exchequer and a group of eight leading asset managers and the Investor Forum, committed to developing an Action Plan on how the investment industry can play its part by encouraging long-term investment. As major allocators of capital and through our interaction with investee companies, our members are major contributors to UK competitiveness and productivity.

Recognising the importance of the asset management industry as the critical link between savers and the real economy, this report is the result of a six month review of the role of the investment industry in supporting productivity improvements with long-term investment. Intellectual stewardship and guidance was provided by an actively engaged Steering Committee, comprised of the CEOs and senior fund managers of some of the largest investors in the UK economy.

The first step of the Steering Committee was to develop a framework for considering the key components of, and challenges to, long-term investment. This was reflected in the development of five key Investor Productivity Principles which articulate a vision for the appropriate role of the investment industry and directed the scope of the review. This informed the analysis of the Committee and formed the basis for the conclusions and the Action Plan.

The Action Plan comprises a package of five overarching objectives, addressing the challenge from a systemic, macro perspective, in terms of the functioning of regulatory regime and capital markets, and from a micro, bottom-up perspective, in terms of the reporting of companies and the stewardship of investors. Each objective is underpinned by a series of recommendations. To deliver these, a series of tangible actions are proposed and each represents a future work programme in its own right.

It is important that this report does not gather dust, and therefore a clear measurement of the success of each recommendation is also stated, and the progress on delivering the Action Plan will be reviewed every six months. The IA will send a letter to the Chancellor on the first and third anniversaries of publication of the Action Plan to outline progress against the individual recommendations and actions.

"THE IA WILL SEND A LETTER TO THE CHANCELLOR ON THE FIRST AND THIRD ANNIVERSARIES OF PUBLICATION OF THE ACTION PLAN TO OUTLINE PROGRESS AGAINST THE INDIVIDUAL RECOMMENDATIONS AND ACTIONS."

INVESTOR PRODUCTIVITY PRINCIPLES

There has been a great deal of debate among economists over the causes of the UK's so-called 'productivity puzzle'. It is clear that very wide-ranging and multidimensional factors contribute to economic productivity, and it is not the intention of this review to provide definitive answers to this broader debate. Our chief concern relates to how the investment industry can play its part. It is therefore important to articulate the appropriate role of investors in improving productivity.

By articulating a set of fundamental principles that seek to define an ideal framework for how investors can contribute to productivity improvements with long-term investment, we can diagnose the current system's short-comings and begin to identify solutions that can address these challenges. The following set of Principles were developed by the Steering Committee as a way to examine the appropriate role and responsibilities of asset managers in contributing to productivity and, in turn, to analyse the challenges presented in fulfilling them.

PRINCIPLE 1

Enhance company reporting for efficient capital allocations: *through investment and analytical expertise, the investment industry will seek to identify and finance those companies contributing productive growth in the economy.*

The design and implementation of an asset manager's investment process, including its analytical capabilities and decision-making, are core features of its business model. The success of these will contribute to investment performance and the delivery of the investment objectives of clients. To deliver client outcomes, among other investment strategies, asset managers will assess the prospects of companies and seek to identify those most able to deliver value to shareholders over the long term. This entails an assessment of the management of, and likely return on, invested capital by companies.

The extent to which a company is able to provide a return on invested capital, whether by managing its cost-base or increasing its sales through business investment, will determine its long-term profitability and success. Therefore, in this context, a company's long-term capital efficiency will determine its productivity. However, for there to be efficient allocation of capital by asset managers that rewards companies for improving productivity and/or those investing to improve capital efficiency, then company reporting, accounting standards and investment research must enable such analysis by asset managers.

> "BY ARTICULATING A SET OF FUNDAMENTAL PRINCIPLES THAT SEEK TO DEFINE AN IDEAL FRAMEWORK FOR HOW INVESTORS CAN CONTRIBUTE TO PRODUCTIVITY IMPROVEMENTS WITH LONG-TERM INVESTMENT, WE CAN DIAGNOSE THE CURRENT SYSTEM'S SHORT-COMINGS AND BEGIN TO IDENTIFY SOLUTIONS THAT CAN ADDRESS THESE CHALLENGES."

PRINCIPLE 2

Enhance investor stewardship and engagement: *the investment industry will engage with companies to help them achieve sustainable value creation over the long term and support investments in improved productivity.*

While the primary responsibility for promoting the success of a company rests with the Board and its oversight of management, investors play a crucial role in holding the Board to account for the fulfilment of its responsibilities. Shareholder stewardship should aim to promote the long-term success of companies in such a way that the ultimate providers of capital will also prosper. In this sense, there should be a natural alignment of interests: effective stewardship should benefit companies, investors and the economy as a whole.

Supporting long-term investment and productivity requires effective dialogue between investors and companies. By exercising stewardship responsibilities effectively, investors are well placed to ensure companies adopt a long-term approach. For example, through purposeful dialogue, shareholders can demonstrate support for expenditures that will boost productivity and challenge companies compromising it as a result of poor capital management.

To the extent that institutional investors incorporate productivity into their engagement, it is important for investors to support and challenge corporate expenditures so as to ensure sustainable capital management. For example, challenging expenditures which are not appropriately linked to the long term strategic plan, or where companies are reducing equity through unjustified share buybacks.

PRINCIPLE 3

Simplify behavioural incentives and the investment chain: *the investment industry will work to ensure that the agreed incentives and governance of the investment chain ensure a clear alignment with clients' long-term investment objectives.*

The investment chain is a term often used to describe the structure of shareholding of listed companies, reflecting that there is a chain of intermediation from beneficial owners, the 'savers', to the asset managers, the ultimate portfolio decision-maker. In reality, this is more of a capital cycle, and forms the financial architecture by which savings are channelled from households, invested by asset managers, and ensures the supply of finance to meet the growing investment needs of the economy.

Economic theory suggests that interests are aligned throughout this chain, from beneficiaries (the owners of capital), to pension fund trustees, investment consultants, investment managers, and the ultimate recipients of capital, the listed companies. Meanwhile, the company responds to the signals from its owners by managing returns to them over the long term. Hence, an efficient capital market transfers today's savings into tomorrow's investment, and long-term growth should prevail.

The Kay Review[2] provided a comprehensive analysis of the agency problems connected with the investment chain of intermediation, including the direct and indirect impediments to adopting a long-term approach. However there remain a number of areas that require further consideration so as to ensure the relationship between asset owners and asset managers is governed in a way that embeds a long-term investment approach.

[2] J. Kay (2012) The Kay Review of UK Equity Markets and Long-term Decision Making: Final Report. Dept. of Business Innovation and Skills. Available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf

PRINCIPLE 4

Develop efficient and diverse capital markets: *as key capital market participants, the investment industry has a key role in the development of asset classes and the efficient functioning of capital markets.*

To catalyse UK productivity growth, companies must be able to access the finance they need to invest in new technology and growth. This requires an investment environment that supports efficient and diverse capital, and protects the interests of investors. Therefore, our collective influence as shareholders needs to be complemented by policy measures to enable capital markets to function more efficiently.

As perpetual capital, equity investment provides the best "slow money" for long-term productive growth. There is also more that can be done to improve the flow of institutional funds into other asset classes issued by both large and smaller companies. A broad spectrum of financial instruments and other asset classes should be available to support long-term investment. Subject to clients' risk and reward requirements, the asset management industry is well positioned to help develop other capital markets in the UK such as private placements, municipal bonds, local authority debt markets and securitisations.

PRINCIPLE 5

Overcome tax and regulatory impediments to support the provision of long-term finance: *the investment industry should contribute to the debate on the tax and regulatory impediments to investment so as to ensure the right long-term outcomes for clients.*

While investors have different mandates, investment strategies, incentives and knowledge of the markets in which they are investing, regulatory and tax developments remain an important factor in shaping the asset allocation strategies of institutional investors. Both have important implications for long-term investment and financial stability.

On the supply side, the tax system continues to incentivise businesses to use debt rather than equity finance, and the extent to which this "debt-bias" might contribute to pro-cyclicality and financial instability is increasingly a focus of regulators. On the demand side, there is a concern that solvency regulation is inadvertently impeding long-term asset allocation strategies. The extent to which both might be linked to pro-cyclical investment outcomes and financial stability, is a matter of continued review by the Bank of England.

ONE OF THE GOALS OF THE FINANCIAL SYSTEM IS TO EFFICIENTLY TRANSFER SAVINGS FROM TODAY INTO INVESTMENT TOMORROW AND GROWTH THE DAY AFTER. IN REALITY, HOWEVER, LONG-TERM FINANCING IS NOT ALWAYS EXECUTED WITH TERMS AND VEHICLES THAT ARE APPROPRIATELY TAILORED TO THE LONG-TERM INVESTMENT OBJECTIVES OF THE ULTIMATE SAVERS. THE FOLLOWING ACTION PLAN ANALYSES HOW EACH STAGE IN THIS FRAMEWORK CURRENTLY FUNCTIONS, IDENTIFIES AREAS IN WHICH THE SYSTEM FALLS SHORT OF THE PRINCIPLES DESCRIBED ABOVE, AND PROPOSES A SERIES OF RECOMMENDATIONS AND ACTIONS TO ADDRESS THEM.

SUMMARY ACTION PLAN

1 ENHANCE COMPANY REPORTING FOR EFFICIENT CAPITAL ALLOCATION:

Recommendation 1: Improve reporting and research on productivity and re-focus on longer-term strategic drivers

ACTIONS:

- Seek clearer articulation and measurement of the long-term drivers of productivity and work with companies to develop appropriate Key Performance Indicators.
- Issue a Public Position Statement calling for listed companies to cease reporting quarterly and refocus reporting on a broader range of strategic issues.
- Call for the provision of increased Longer-Term and Thematic Investment Research.

Recommendation 2: Improve reporting on capital management and clarify investor expectations of capital management

ACTIONS:

- Work with companies to improve how they articulate their capital management strategy and reporting of outcomes.
- Encourage the FRC's Financial Reporting Lab to undertake a project to develop best practice guidance on the consistent disclosure of a company's cost of capital.
- Develop an investment industry Public Position Statement on how investor engagement can support and challenge company capital management decisions.

Recommendation 3: Improve reporting on culture, human capital and accounting for intangibles

ACTION:

- Raise the profile of Human Capital Management as a material investment consideration and promote better company reporting to facilitate enhanced investor analysis.
- Support the work of the FRC's Culture Project.
- Engage with the IASB to expedite its research on accounting for intangible assets.

2 ENHANCE INVESTOR STEWARDSHIP AND ENGAGEMENT:

Recommendation 4: More formally incorporate a focus on long-term value creation and productivity into engagement practices

ACTIONS:

- Seek wider support and financing for the work of the Investor Forum by launching an independent membership fee.
- Support asset managers in the public reporting of stewardship activities.

3 SIMPLIFY BEHAVIOURAL INCENTIVES AND THE INVESTMENT CHAIN:

Recommendation 5: Ensure that the relationship between asset owners and investment managers is governed in way that does not inadvertently embed a short-term focus

ACTIONS:

- Work with the Pensions Regulator, the PLSA, and investment consultants to develop best-practice guidance on how stewardship and long-term incentives can be better incorporated into the Statement of Investment Principles and Mandate design.
- Investment consultants are encouraged to issue public position statements describing how their activities support the provision of long-term investment approaches and stewardship in mandate design and performance evaluation.

Recommendation 6: Consideration of how greater opportunities for long-term investment can be made available to investors in defined contribution schemes

ACTION:

- Establish a Working Group of key stakeholders to consider the key regulatory and market barriers to creating a DC investment environment more suited to long term investment.

Recommendation 7: Foster improved understanding of the investment horizons of investment managers

ACTION:

- Examine methodologies for calculating average holding periods with a view to developing a standard approach across the industry.

Recommendation 8: Ensure that executive remuneration structures are aligned to long-term decision making

ACTION:

- Consider the findings of the Executive Remuneration Working Group's review of executive remuneration structures and launch an extensive programme of engagement with listed companies.

4 DEVELOP EFFICIENT AND DIVERSE CAPITAL MARKETS:

Recommendation 9: Encourage Equity Investment and Improve the Equity Offering Process

ACTIONS:

- Develop earlier engagement between institutional investors and small and mid-size early stage pre-IPO companies.
- Lower the cost of issuing equity capital and removing the information asymmetry that exists at the expense of investors.
- Engage with the European Commissions on the proposed Prospectus Regulation.
- Engage with key stakeholders to improve and support the efficiency of the secondary market capital raising process whilst maintaining investor protections.

Recommendation 10: Ensure the efficient operation of the markets for other asset classes to ensure the provision of diverse capital markets

ACTIONS:

- Continue to engage with the European Commission on the proposed Prospectus Regulation to promote the key priorities of asset managers for non-equity securities.
- Promote a more efficient new issuance process in fixed income markets and aide secondary market liquidity through the use of clear terminology and standard definitions in covenants for sterling and euro bond issues.
- Promote appropriate behaviours and investor expectations in fixed income markets and support the work of the Financial Markets Standards Board and the FCA Debt Markets Forum.
- Develop and promote guidelines for Housing Associations raising capital in public markets.
- Work with the UK Municipal Agency to promote the development of a UK municipal bond market and highlight the interest of investors in this sector.
- Support on-going work to develop European Private Placements and the revival of the securitisation market in UK and Europe.

5 OVERCOME TAX AND REGULATORY IMPEDIMENTS TO THE PROVISION OF LONG-TERM FINANCE:

Recommendation 11: Ensure that solvency and prudential regulation does not inadvertently impede investment managers from investing in a manner consistent with their clients' long-term interests

ACTIONS:

- Encourage the FCA to undertake a thematic review of whether the approach to market risk in prudential and conduct regulation is resulting in investment decisions that are consistent with the long-term investment objectives of clients.
- Convene a multi-stakeholder Working Group to review the extent to which current accounting standards and solvency and prudential regulatory requirements may be resulting in excessive de-risking by insurers and pension funds and impeding the provision of longer-term forms of finance.

Recommendation 12: Review the causes of "debt-bias" and its effect on financial stability and procyclical decision-making

ACTION:

- Undertake a comprehensive review of why companies favour funding through debt rather than equity.

The Investment Association
Camomile Court, 23 Camomile Street, London, EC3A 7LL

www.theinvestmentassociation.org

@InvAssoc

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